PREPARED STATEMENT OF

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BEFORE THE

SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK MANAGEMENT

COMMITTEE ON AGRICULTURE

UNITED STATES HOUSE OF REPRESENTATIVES

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Mr. Chairman and Members of the Subcommittee, I appreciate your invitation to testify on behalf of ISDA. We have appeared frequently before the Subcommittee in prior years and we welcome the opportunity to be with you today as you continue your important hearings with respect to legislation to reauthorize the Commodity Futures Trading Commission (the "CFTC"). The CFTC administers the Commodity Exchange Act (the "CEA"), which Congress substantially amended in the Commodity Futures Modernization Act of 2000 (CFMA).

I.

Overview

ISDA is an international organization, and its more than 600 members include the world's leading dealers in swaps and other off-exchange derivatives transactions (OTC derivatives). ISDA's membership also includes many of the businesses, financial institutions, governmental entities, and other end users that rely on OTC derivatives to manage the financial, commodity market, credit, and other risks inherent in their core economic activities with a degree of efficiency and effectiveness that would not otherwise be possible.

The CFMA was adopted by Congress with broad bipartisan support after careful consideration over several years by four Congressional Committees and with the support of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission and the Chairman of the CFTC. The CFMA sought to modernize the CEA by providing regulatory relief for the futures exchanges, ensuring legal certainty for OTC derivatives, and removing the ban on single-stock futures trading.

For the reasons I shall explain in this statement, ISDA believes that the experience under the CFMA demonstrates that there is no fundamental need to make substantive changes to the portions of the CMFA governing OTC derivatives. Moreover, from all indications, the CFMA seems to have been a broad-based success for the capital markets generally.

We understand that the Subcommittee will want to receive a full range of views concerning the CFMA and we believe this is desirable. We do, however, urge the Subcommittee to take a "go slow" approach to re-opening the CFMA. We also urge the Subcommittee to assert fully its jurisdiction to review and approve any changes to the CFMA. Our experience in recent years demonstrates that the use of free-standing amendments offered to separate legislation without committee review is an undesirable method of considering changes.

II.

ISDA's Interest in the CFMA

ISDA's principal interest in the CFMA are those provisions of the legislation intended to provide legal certainty for OTC derivatives. The phrase "legal certainty" means simply that the parties to an OTC derivatives transaction must be certain that their contracts will be enforceable in accordance with their terms. As discussed more fully in Part III of this Statement, the CFMA framework for providing legal certainty is based on a long-standing consensus among Congress, the CFTC and others that OTC derivatives transactions generally are not appropriately regulated as futures contracts under the CEA.

The legal certainty provisions of the CFMA were intended by Congress both to reduce systemic risk and promote financial innovation. Our experience over the past several years indicates that both of these objectives have been achieved. A survey of corporate usage of derivatives released by ISDA in April 2003 indicated that 92 percent of the world's largest businesses use OTC derivatives for risk management purposes and that 94 percent of the 196 U.S. companies included in the survey do so.

Moreover, the use of OTC derivatives to hedge interest rate, foreign currency and credit default risks increased substantially in the last four years, evidencing the importance of OTC derivatives as a tool to manage risk in periods of economic downturn and uncertainty.[1] As Federal Reserve Chairman Alan Greenspan noted before the Senate Banking Committee on March 2, 2002, OTC derivatives "are a major contributor to the flexibility and resiliency of our financial system." The reduction in systemic risk resulting from the use of OTC derivatives was also evident in the energy markets following the collapse of Enron in 2001. Indeed, it appears that the legal certainty provisions of the CFMA and the related provisions of the Bankruptcy Code (adopted by Congress in 1990) may have enhanced the ability of market participants to deal effectively with events such as the collapse of Enron.

The reductions in systemic risk resulting from enactment of the legal certainty provisions of the CFMA have <u>not</u> come at the expense of financial innovation. New types of OTC derivatives have gained increased market acceptance since enactment of the CFMA. For example, the significant growth in credit default swaps to manage credit risk has been greatly enhanced by the legal certainty provisions of the CFMA. Similarly, businesses ranging from ski resorts to beverage producers have begun to use weather derivatives to hedge the risk of adverse climate conditions on their businesses. Again, the legal certainty provisions of the CFMA have encouraged dealers to develop, and businesses to use, an increasing range of new kinds of OTC derivatives to manage additional types of risk. Finally, the legal certainty provisions of the CFMA removed the regulatory barriers to clearing with respect to OTC derivatives and, while collaterized transactions remain more prevalent, clearing proposals have been advanced recently and

[1] See Exhibit 1 (Derivatives Growth, 2000-2004, Source: ISDA).

the emergence of these proposals attests to the positive effects of the CFMA on financial innovation.

For these reasons, ISDA shares the view expressed by CFTC Chairman Sharon Brown-Hruska that the CFMA "functions exceptionally well." In this connection ISDA believes that the CFTC deserves commendation for the evenhanded manner in which it has interpreted and administered the CFMA in accordance with Congressional intent, as well as for its vigorous program of enforcement following the collapse of Enron and the California energy situation. ISDA's primary members are substantial users of the regulated futures exchanges. ISDA therefore supported the provisions of the CFMA that provided regulatory relief to the exchanges and since then has welcomed the actions of the CFTC in implementing those portions of the CFMA in a manner that appears likely to promote efficiency and competition.

The legal certainty agenda remains incomplete, despite the historic advances embodied in the CFMA. Congress still needs to focus on completing action on the financial contract netting provisions contained in the pending bankruptcy reform legislation. These provisions have broad bipartisan support, have passed both the House and the Senate on multiple occasions without opposition, reflect years of work by the President's Working Group on Financial Markets and include much needed improvement to the payment risk reduction and netting provisions of the Bankruptcy Code and the bank insolvency laws.

III.

Development of the Legal Certainty Consensus

Importance of OTC Derivatives. OTC derivatives are powerful tools that enable financial institutions, businesses, governmental entities, and other end users to manage the financial, commodity, credit and other risks that are inherent in their core economic activities. In this way, businesses and other end users of OTC derivatives are able to lower their cost of capital, manage their credit exposures, and increase their competitiveness both in the United States and abroad. Almost all OTC derivatives

transactions involve sophisticated counterparties, and, unlike the futures markets, there is virtually no "retail" market for these transactions.

The use of OTC derivatives is a positive force in the financial markets. As Federal Reserve Chairman Greenspan noted at a Senate Banking Committee hearing (March 7, 2002) "they (derivatives) are a major contributor to the flexibility and resiliency of our financial system. Because remember what derivatives do. They shift risk from those who are undesirous or incapable of absorbing it to those who are." OTC derivatives are used to unbundle risks and transfer those risks to parties that are able and willing to accept them. For example, if a corporation has floating rate debt outstanding and is concerned that interest rates might rise, it could use an interest rate swap to effectively convert its debt into a fixed rate obligation, thereby fixing its exposure. Similarly, if business has the right to receive non-dollar denominated revenues from a foreign-based affiliate, it could use a currency swap to hedge the risk of exposure to fluctuating exchange rates.

OTC derivatives transactions can be custom tailored to meet the unique needs of individual firms. Due to the tailored nature of such transactions and their bilateral nature, and other factors, OTC derivatives differ substantially from the standardized exchange-traded futures contracts regulated by the CFTC. In a typical OTC derivatives transaction, two counterparties enter into an agreement to exchange cash flows at periodic intervals during the term of the agreement. The cash flows are determined by applying a prearranged formula to the "notional" principal amount of the transaction. In most cases, such as interest rate swaps, this notional principal amount never changes hands and is merely used as a reference for calculating the cash flows. Almost any kind of OTC derivative can be created. The flexibility and benefits that these transactions provide have led to their dramatic growth. In addition to interest rate and currency transactions, commodity, equity, credit and other types of transactions are widely used. Transactions take place around the world, but the United States has been a leader in the development of OTC derivatives transactions, and American businesses were among the earliest to benefit from these risk management tools. The dramatic growth in the volume and

diversity of OTC derivatives transactions is the best evidence of their importance to, and acceptance by, end users.

While its use is a matter of choice among the parties to the transaction, almost all OTC derivatives contracts both within and outside the United States are based on a Master Agreement published by ISDA. The ISDA Master Agreement is a standard form and governs the legal and credit relationship between counterparties, and incorporates counterparty risk mitigation practices such as netting and allows for collateralization. The ISDA Master Agreement also addresses issues related to bankruptcy and insolvency, such as netting, valuation and payment. The strength of the ISDA documentation and the important actions taken by Congress (and regulators) to ensure that OTC derivatives contracts would be enforceable in accordance with their terms have contributed positively to the ability of the financial and commodity markets to absorb events such as the Enron bankruptcy without systemic risk.

Legal Certainty and the CEA. The availability of OTC derivatives transactions within a strong legal framework is of vital importance. Any uncertainty with respect to the enforceability of OTC derivatives contracts obviously presents a significant source of risk to individual parties to those specific transactions. Moreover, any legal uncertainty creates risks for the financial markets as a whole and precludes the full realization of the powerful risk management benefits that OTC derivatives transactions provide. One of ISDA's principal goals since its inception has been to promote legal certainty for OTC derivatives transactions.

"Legal certainty" simply means that parties must be certain that the provisions of their OTC derivatives contracts will be enforceable in accordance with their terms. For example, ISDA has sought to establish (i) clarity concerning how OTC derivatives transactions will be treated under the laws and regulations of the United States as well as many other countries; (ii) certainty that OTC derivatives transactions will be legally enforceable in accordance with their terms and not subject to avoidance; and (iii) certainty that key provisions of OTC derivatives transactions (including netting and termination provisions) will be enforceable, even in the case of the bankruptcy of one of the parties. Within the United States, until the adoption of the CFMA, the CEA was the

major source of legal uncertainty with respect to OTC derivatives. As discussed below, both Congress and the CFTC have since the late 1980s acted to provide increased legal certainty for OTC derivatives.

The original version of what is now the CEA was enacted in 1922 to ensure that participants in the commodities futures markets were not defrauded and that those markets, which served significant price discovery functions, were not manipulated. To achieve these objectives, the CEA required, and still requires, that all futures contracts on covered commodities be traded on a government-regulated futures exchange. Under this "exchange-trading requirement", all futures contracts that are not traded on a regulated futures exchange are illegal and unenforceable.

As originally enacted, the CEA applied only with respect to certain agricultural commodities. In 1974, the CEA was substantially revised by (i) establishing the CFTC as an independent agency to administer the CEA; (ii) expanding the definition of "commodity" to include (with certain exceptions) "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt with"; and (iii) at the request of the Treasury Department, providing a statutory exclusion from the CEA for transactions in or involving government securities, foreign currencies and certain other similar commodities.

1989 Swaps Policy Statement. In the late 1980s, the use of interest rate and currency swaps and other OTC derivatives transactions to manage financial risks grew rapidly. At this time, there was a consensus that OTC derivatives were not "futures" contracts. Nevertheless, because of certain perceived similarities between OTC derivatives and exchange traded futures contracts, there was residual concern that the CFTC or a court might treat OTC derivatives contracts as futures, which would render them illegal and unenforceable by reason of the CEA's exchange trading requirement.

To address these concerns, the CFTC issued a Swaps Policy Statement in 1989 stating its view ". . . . that at this time most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the CEA. . . ." The CFTC also established a nonexclusive safe harbor for swaps transactions that met certain requirements (e.g., that they were undertaken in connection with a line of

business and not marketed to the general public). The Swaps Policy Statement provided legal certainty that the CFTC would not initiate enforcement actions with respect to OTC derivatives that satisfied the safe harbor, but it did not and could not eliminate the risk that a counterparty to an OTC derivatives contract would attempt to avoid its contractual obligations by seeking a court ruling that the contract was an illegal off-exchange "futures" contract.

Futures Trading Practices Act of 1992 (FTPA). In 1992, Congress itself took a crucial step to provide legal certainty that the CEA was not applicable to OTC derivatives by passing the FTPA. In this important legislation Congress provided the CFTC with explicit statutory authority to issue exemptions from the CEA. The purpose of granting this exemptive authority was ". . . to give the [CFTC] a means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner."

In passing the FTPA, Congress specifically directed the CFTC to resolve legal certainty concerns with respect to OTC derivatives by promulgating an exemption for swaps and certain hybrid contracts. In order to avoid any implication that any class of OTC derivatives transactions were "futures," the Congress made it very clear that granting of an exemption does not ". . . require any determination beforehand that the agreement, instrument or transaction for which an exemption is sought is subject to the [CEA]."

1993 CFTC Exemptions. In response to the FTPA, the CFTC adopted a series of exemptions. In January 1993, the CFTC issued the Swaps Exemption and an exemption for hybrid instruments. The Swaps Exemption exempted certain types of OTC derivatives, when entered into between sophisticated counterparties, from most provisions of the CEA, including the exchange-trading requirement. In general, the Swaps Exemption covered a broader range of contracts than did the 1989 Swaps Policy Statement, but some types of OTC derivatives were not covered (e.g., other provisions of the CEA precluded application of the Swaps Exemption to OTC derivatives based on securities). In April 1993, the CFTC also issued an exemption for certain contracts involving specified energy products when entered into between commercial participants.

This exemption, issued after notice and opportunity for public comment, was also intended to provide legal certainty that the covered energy contracts were not subject to regulation under the CEA.

1998 CFTC Concept Release and Congressional Moratorium. Despite these efforts by Congress and the CFTC to provide increased lega1 certainty that most OTC derivatives were not appropriately regulated as futures under the CEA, concerns continued to exist. These concerns proved to be neither academic nor speculative. In 1998, the CFTC issued a so-called "Concept Release" on OTC derivatives. As described by this Committee, the Concept Release

> ". . . was perceived by many as foreshadowing possible regulation of these instruments [OTC derivatives] as futures. The possibility of regulatory action had considerable ramifications, given the size and importance of the OTC market. This action [by the CFTC] significantly magnified the long-standing legal uncertainty surrounding these instruments, raising concerns in the OTC market, including suggestions it would cause portions of the market to move overseas.
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> "This prospect led the Treasury, the Fed and the SEC to oppose the concept release and request that Congress enact a moratorium on the CFTC's ability to regulate these instruments until after the [President's] Working Group [on Financial Markets] could complete a stuffy of the issue. As a result, Congress passed a six-month moratorium on the CFTC's ability to regulate OTC derivatives." S. Rep. No. 103-390 (2000).

1999 President's Working Group Report. On November 15, 1999, the President's Working Group on Financial Markets issued its report entitled *Over-the-Counter Derivatives Markets and the Commodity Exchange Act.* The Report reflected an extraordinary consensus reached by the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission and the Chairman of the CFTC. It recommended that Congress enact legislation explicitly to clarify that most OTC derivatives transactions involving

financial commodities generally are excluded from the CEA. As stated in the Report, " . . . an environment of legal certainty . . . will help reduce systemic risk in the financial markets and enhance the competitiveness of the U.S. financial sector". Indeed, as the Report also noted, the failure to enact such legislation ". . . would perpetuate legal uncertainty and impose unnecessary regulatory burdens and constraints upon the development of these markets within the United States."

Commodity Futures Modernization Act of 2000 (CFMA). In December 2000, Congress passed the CFMA. This specific legislation was the product of more than two years of consideration. Four Committees of the Congress held hearings on and formally approved the legislation. At these hearings and elsewhere, key financial regulators (the Treasury, the Federal Reserve, the SEC and the CFTC) and other interested parties presented and debated the merits of various alternative proposals. At each stage of its consideration, bipartisan majorities approved the CFMA.

The principal purpose of the legislation was to eliminate, and not merely reduce, uncertainty with respect to the legal and regulatory status of most OTC derivatives transactions involving sophisticated counterparties. In this respect, as demonstrated by the preceding discussion, the CFMA did not mark a radical departure from prior policy. For more than a decade prior to passage of the CFMA, Congress and the CFTC had worked diligently and almost without exception to provide increased legal certainty that OTC derivatives transactions were not appropriately regulated as futures contracts under the CEA. The CFMA was therefore a culmination of a long and deliberate process to provide legal certainty for OTC derivatives and thereby reduce systemic risk and promote financial innovation.

IV.

Experience Under the CFMA

Our experience to date under the CFMA indicates that Congress did indeed achieve its objective of providing legal certainty and regulatory clarity for OTC derivatives in a manner that would both reduce systemic risk and promote financial innovation. As noted above, the increased use of interest rate, foreign currency and credit derivatives has enabled American businesses and financial institutions to manage these

key financial risks more effectively during the current economic downturn than would have otherwise been possible. In addition, the development of new types of OTC derivatives to manage other types of risks, as well as the emergence of clearing proposals, is evidence that the CFMA has created a climate that fosters financial innovation.

Equally significant, three events since the passage of the CFMA have in many ways "stress tested" the OTC derivatives markets and the applicable provisions of the CFMA itself. The results have been encouraging. First, there is no question but that the CFMA structure enabled firms to deal with the economic downturn in the early part of this decade in a more effective manner. The well publicized events leading to Enron's bankruptcy filing in December 2001 presented a second test. Enron raised serious concerns involving accounting practices, securities law disclosures and corporate governance policies. These issues received serious attention from policymakers and the Enron situation contributed to the decision of Congress to enact the Sarbanes-Oxley Act of 2002. Moreover, the CFTC and other regulators conducted intensive investigations (some of which are ongoing) and initiated a broad range of enforcement actions, including actions based on the CFMA.

ISDA also carefully considered the possible implication of the Enron collapse. In a detailed study entitled "Enron: Corporate Failure, Market Success," released in April 2002 (available on ISDA's web site), ISDA concluded that OTC derivatives did not cause, or contribute materially to, Enron's failure. Had Enron complied with accounting and disclosure requirements, it could not have built the "house of cards" that eventually led to its downfall. The market in the end exercised the ultimate sanction over Enron and the market for swaps and other OTC derivatives worked as expected and experienced no apparent disruption. The OTC derivative market did not fail to function in the Enron episode. Indeed, market participants have learned much about risk management in recent years. Considering the size of Enron, it is important to note that its failure did not have a systemic impact.

The equally well-publicized transactions of Enron and others in or with respect to the California energy market presented a third test involving different public policy questions; namely, the design of the California electricity market, the lack of adequate

reserves, demand response relative to growing electricity demand and possible manipulation of the wholesale market. ISDA views any credible allegations of "manipulation" in financial or other markets as a serious matter requiring attention and therefore welcomed the investigations by the appropriate federal agencies and departments, including the CFTC, the Federal Energy Regulatory Commission (FERC) and the Department of Justice. Both FERC and the CFTC have now initiated a series of enforcement actions employing the tools available under existing law, including the CFMA. Based on this experience, there does not appear to be any specific evidence that the Commission's antimanipulation authority is deficient.

In 2003, ISDA released a white paper entitle "Restoring Confidence in the U.S. events that led to the loss of confidence in these markets, the paper identified the regulatory framework (as enhanced by the CFMA) as one of the factors that was effective in countering the fallout from market events. As in the case of the Enron bankruptcy, the CFMA contributed to the ability of the markets to respond to a difficult situation with potentially broad ranging impact.

IV.

Conclusion

OTC derivatives are a considerable contributor to the flexibility and resiliency of our financial system. They allow businesses, financial institutions, governmental entities and other end users to manage the financial, commodity, credit and other risks inherent in their core economic activities in an efficient manner. The CFMA provide legal certainty and regulatory clarity for OTC derivatives in a manner consistent with the long-standing policies of Congress and the CFTC that OTC derivatives are not appropriately regulated under the CEA as futures contracts. This policy, now codified in the CFMA, materially reduces systemic risk and encourages financial innovation. The economic downturn at the beginning of this decade, and the manner in which the OTC derivatives markets functioned in the case of the collapse of Enron and the California energy market situation, have, together with the enforcement actions of the CFTC under the CFMA, confirmed that the policy judgments Congress made in 2000 were sound then and remain so today.